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SUBJECT: DAS BRYZA'S MEETINGS WITH RUSSIAN AND WESTERN
ENERGY OFFICIALS

Classified By: EconMinCounselor Eric T. Schultz. Reasons 1.4 (b/d).

¶1. (C) SUMMARY. In July 31-August 1 meetings, DAS Bryza's discussions with MFA, western and Russian energy officials centered on oil pipeline issues and Eurasian gas developments. Transneft head Vainshtok criticized the Caspian Pipeline Consortium, (CPC) and suggested it should only be expanded to support the Burgas-Alexandropoulos pipeline (BAP). He also defended Russian oil cutoffs to Lithuania and Belarus last year. Chevron head Ian MacDonald said the key to resolving the dispute over CPC's expansion lies in the agreement accepted by shareholders but still awaiting Russian approval and noted that BAP's ownership model is not currently attractive. The centrality of Turkmenistan to Europe's future gas supply diversification figured strongly in discussions. Most western companies expect the State's hold over the energy sector will continue but also predict a significant production crisis sometime in the future. END SUMMARY.

Caspian Pipeline Consortium (CPC)

¶2. (C) Discussing the Caspian Pipeline Consortium, Transneft President Semyon Vainshtok repeated oft-used complaints to Bryza, calling CPC "technically bankrupt" and a "cash cow" for the shareholders. Of some \$600 million in annual revenue, he said, \$100 million goes to operations and \$500 million goes to the western shareholders to service debt on their own loans. No money goes to Russia and the consortium pays no taxes. Moreover the debt's interest rate, at 12.66 percent, is too high in today's markets. "Why should we let them pay these rates to themselves?", Vainshtok asked. Transneft offers to the consortium's shareholders to resolve the debt problem have so far been rebuffed, and Vainshtok blamed shareholders that use CPC as a "cash machine at the expense of Russia." He identified ExxonMobil, BP, and Shell in this category, characterizing them as "bandits". By contrast, he said, shippers such as Chevron seem interested in resolving the financial morass and show more willingness to consider lower interest rates and higher tariffs. Transneft has offered to assist in refinancing CPC's debt via Eurobonds but this was also rejected.

¶3. (C) Vainshtok also stated that Transneft has no qualms about CPC's existence and the Russian state is not aiming for more control or a greater share of the consortium but rather wants the project to be profitable and better-managed.

Transneft does not view CPC as a competitor and, because its tariffs are high compared with Transneft's, CPC "makes me look good", Vainshtok emphasized. He complained about CPC's governance structure in which a committee of shareholder representatives makes key decisions, arguing it should be more businesslike with a board, an executive cadre, and company management. According to Vainshtok, President Putin wants CPC to be a successful, prosperous enterprise and a concrete example of cooperation with the United States and he is well aware of the value President Bush places on it, but Vainshtok said CPC sets a "bad example."

¶ 4. (C) Ian MacDonald, former head of CPC and now Chevron's chief in Moscow, told Bryza separately that all shareholders are ready to sign an agreement on refinancing CPC's debt and raising the tariff to resolve CPC's financial straits if they gain relief from Russia's aggressive attempts to take over the consortium's governance and Russian approval for pipeline expansion which would resolve CPC's financial problems. Issues such as Transneft's new offer to refinance debt via Eurobonds, while intriguing to some shareholders, are essentially irrelevant since the financial issues have been resolved in the agreement that has been awaiting Russian approval for some time. MacDonald pointed out that, in addition to some Kazakhstani shippers failing to deliver volumes on time, CPC's financial condition was largely due to the GOR's multi-year dithering over expansion.

BURGAS-ALEXANDROPOLOS Pipeline (BAP)

¶ 5. (C) Regardless of CPC's financial situation, Vainshtok added, it cannot be expanded until BAP makes some progress. The Black Sea currently receives 107 million tons of oil

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annually outbound through the Straits and it cannot handle any more. Responding to Bryza's point that no one has established a formal numerical limit on transit through the Straits, Vainshtok praised U.S. support for Turkey's Vehicle Traffic System (VTS) but said that Transneft's experts had concluded that VTS data shows that the limit has been reached. Any new oil entering the Black Sea will have a negative impact on everyone. "We are mutually closed in", he said. He recalled a recent accident in which a tanker lost control in the Straits, backing up traffic for many days, causing substantial losses. Although the Montreux Convention does not allow discrimination by Turkey of ships transiting the straits, he claimed that new regulations Turkey is permitted to use managing traffic will result in discrimination against Russian tankers, especially if the additional oil entering the Black Sea to exit via the Straits is non-Russian oil. "CPC means less for us," Vainshtok concluded.

¶ 6. (C) The solution is BAP. Vainshtok painted a scenario in which CPC's expansion of roughly 35 million tons would go largely to BAP, with an additional 5 million tons from Tuapse. With Russian companies owning 51 percent of BAP, who owns the other 49 percent is unimportant to Transneft and to Russia, as long as the project is commercially profitable. That way, he said, everyone will be operating on a "half and half" basis -- "CPC gets to send half its volume wherever it wants, and half to us."

¶ 7. (C) MacDonald separately told Bryza that Chevron would support BAP under the right circumstances but that has not been presented yet. Transneft, which is ostensibly to build and manage BAP, clearly wants Chevron and other Kazakhstani shippers to finance the pipeline. Yet, as MacDonald pointed out, Chevron is not interested in 49% of BAP merely as a financial investment, so currently the company sees BAP as a pipeline to use as a customer, not an equity-holder.

BELARUS AND LITHUANIA

¶ 8. (C) Vainshtok defended Transneft's cutoff of oil to Lithuania last year, explaining that RosTeknadzor, one of Russia's regulatory agencies, demanded that the main pipeline be run at reduced pressure after the initial accident that shut off Lithuania's (and part of Belarus') flow. The reduced pressure meant that the oil could not be pumped beyond Belarussian customers. Vainshtok complained that "politicians and analysts" abroad criticized Russia's action as a political act, yet when technical accidents happen at Supsa (Georgia) or on BP's pipeline in Alaska, no one criticizes them. In any event, Vainshtok said, Russia can make \$100 million/year more by shipping the crude through Primorsk than through Lithuania. As for what Lithuania should do, Vainshtok said that the Mazeikiu refinery can "buy crude from anyone it wants" through ports.

¶ 9. (C) Vainshtok defended the previous oil cutoffs to Belarus several months ago, saying that for at least two years, Belarus had simply been stealing wealth from Russia. Under the customs union, Belarus receives oil without export taxes added from Russia and either sells it at world prices or refines it and sells products, without sharing proceeds with Russia. By December 2006, Belarus had "broken all contracts" regarding oil supplies, according to Vainshtok and Russia had to act. The world complained that Russia was an unreliable supplier when in fact all its contractual commitments were being met. Transneft had excellent relationships with transit countries but Belarus had emerged as an "extraordinarily dangerous situation," Vainshtok concluded that Belarus mistakenly thinks that Russia will tolerate Belarussian abuses, however, Russia is finding alternative routes.

TURKMENISTAN

¶ 10. (C) In his meeting with Bryza, Ian MacDonald elaborated on recent press announcements that Chevron is pursuing acreage in Turkmenistan. Chevron wants to secure onshore gas-prone acreage in Central Turkmenistan, including the deeper horizons where Chinese companies are developing the

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shallow portions. Chevron anticipates that gas resources in these deeper horizons could be enormous, and believes that as the world's leader in sub-salt geological reservoirs (such as Tengiz in Kazakhstan), it should be in a good position to help Turkmenistan develop them. Chevron has sent teams to Turkmenistan in recent months, relations are good and improving, and the company has brought Turkmen officials and experts to the United States.

¶ 11. (C) MacDonald said Turkmenistan asked Chevron to consider developing Serdar (Kapaz in Azerbaijan), the disputed offshore field on the same geological trend as Azerbaijan's AIOC fields. Chevron is willing to examine that possibility, but has made it clear that a legal settlement of Serdar/Kapaz' ownership needs to be reached between Turkmenistan and Azerbaijan. MacDonald said it is almost certain that the existing west-bound transportation corridors starting in Baku would be used to carry any resources produced from Serdar/Kapaz. Regarding transportation of potential discoveries of large, new amounts of gas, Chevron supports the concept that alternative routes should be examined. Given the sensitivity of Turkmenistan's position vis-a-vis Russia as Turkmenistan considers alternative investors and alternative routes, MacDonald warned that it is important to tread carefully in the diplomatic realm especially regarding public rhetoric.

WESTERN INDUSTRY VIEWS ON RUSSIAN ENERGY POLITICS

¶ 12. (C) At an Amcham-sponsored meeting, western energy businessmen provided Bryza with a wide-ranging perspective on

internal and external energy developments. Among their observations and recommendations were:

-- The consolidation of the energy sector in the state's hands may or may not have been strategically planned, but the authorities now in charge of the sector have developed what appears to be a "Grand Ambition" which empowers them to control the economy and to project power abroad.

-- The resulting political environment, has left much less room for new ideas to solve problems or enhance efficiency.

-- Nonetheless, many sectors of the economy, including retail, manufacturing and financial services are vibrant and a middle class is developing. Foreign oil companies can work with reduced ownership shares in deposits provided they have budgetary control over projects. Even with the foreign investment restrictions being considered, partnerships with foreign firms can permanently change behavior by demonstrating that business ambitions are better than geopolitical ones, so protecting the "dual key" that gives foreign minority investors some control over budgets and cash flow is essential for companies going forward in Russia. AmCham representatives suggested it would be useful to establish and track some "benchmarks" on how Russia is doing relative to other petro-states.

-- The geopolitical reality of the oil and gas world is that Russia holds huge prizes for those who can run the gauntlet of the Russian system. Observers are puzzled over what Total is getting for its role in Shtokman but generally conclude that the company must believe it is gaining first-mover advantage and will be able to obtain a better deal with Gazprom in the future.

-- It may be a good time for the West to identify the relative progressives in Russia and find ways to reward them, while taking meaningful steps to hobble the more "neanderthal" elements. The members suggested this distinction should be a consideration when viewing Russian investments into the United States. Russian authorities often use the U.S. CFIUS process to justify their own restrictive attitudes toward foreign investment in anything vaguely "strategic," so the U.S. open system should be better explained.

-- Russia's presumed energy prowess is facing trouble in coming years. Production is stagnating and will decline, the state has proven incapable of building a tax and incentive regime to prevent production crises in brownfields, and the

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business model put forward for greenfields (aka Shtokman and some East Siberian fields) is unsuitable for the frontier regions. Most western companies expect production crises sometime in the future, followed by fixes to the broken system, but all this will take time to play out. Electricity reform in Russia is "all screwed up" because Gazprom is replacing much-wanted foreign investors in acquiring spun-off power facilities.

-- There are some demonstrable improvements in transparency and corporate governance in the sector, largely due to the obligations and better governance that have come with Initial Public Offerings and other linkages to global markets. Russian accession to the WTO would bring greater integration and improve the future business climate. However, corruption and collusion remain problematic in Russia despite periodic GOR/Kremlin moves to address them.

MFA'S VIEW

¶13. (C) The Director of the Third Department for Countries in the CIS at the Ministry of Foreign Affairs, Maxim Peshkov told Bryza that Russia is well aware of USG "lobbying" for

various alternative pipeline routes in the region, including cross-Caspian and cross-Afghanistan routes from Turkmenistan.

Peshkov said Russia doubts either will work because of insufficient gas resources in Turkmenistan. A cross-Caspian gas route is also hindered by the lack of delimitation of borders in the sea and because the PriCaspian gas route (onshore along the coast northwards from western Turkmenistan) is cheaper than a cross-Caspian route. Bryza emphasized that the U.S. approach to pipelines in the region is not politicized but rather aimed at building markets. Competition is a fundamental principle of free markets, as are alternative energy sources. The USG believes a cross-Caspian route is economically viable and competitive with alternatives and business will ultimately decide which is best.

¶14. (C) Pehskov asked whether a problem with the "southern corridor" might be Turkey's insistence on a role as a gas broker rather than a simple transit state. Bryza replied that contractual solutions are being found on this issue and cited the recent contract Turkey signed in which Turkey will get 15 percent of the gas and transit the rest. Peshkov wondered whether the relatively cheaper route for Turkmen gas through Iran might throw a wrench in USG promotion of the southern corridor, and noted that Russia finds dealing with Iran very frustrating. Bryza replied that Iranian involvement would clearly pose problems, but based upon our discussions with Europeans working in Iran the USG has little doubt that dealing with Iran may well be fruitless. Agreements Iran signs, such as the recent one with Turkey to transit Turkmen gas, therefore may be little more than a statement of intention.

¶15. (C) Regarding Europe, Peshkov emphasized that Russia has tolerated theft by transit states such as Ukraine and Belarus for too long and is now building alternative routes. This will benefit energy security for consumers and provide diversification and increasingly independent routes. Bryza responded that Europe clearly wants diversified supplies, which is not the same thing as Russia merely moving its "molecules" to different Russian-owned routes. What Europe might consider as diversification is ownership of some of Russia's upstream gas, but Gazprom's monopoly status is a huge hindrance. In the end the customer pays for everything including upstream development. Since Russia needs immense upstream gas investment, the current situation is probably not sustainable and will drive Europe to other gas sources. Pehskov responded that interdependence between Russia and Europe is the glue that holds the system together so which companies operate the fields is not that important.

¶16. (C) On oil pipelines, Pehskov agreed that the CPC pipeline players should find a solution to the current standoff. Bryza stressed that the USG has long supported Bosporus bypasses and would support Burgas-Alexandropoulos if the business community endorses it. He noted that so far it seems most companies would be willing to support BAP if the business structure works. Pundits like to say BAP is a

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strategic loss for the West, but it is quite the opposite -- it is a gain for all energy consumers and energy shippers including Russia. Peshkov said that the viability of a Samsun-Ceyhan route still has too many uncertainties and that more work is needed "by the Turks" to make it attractive. Regarding oil shipments across the Caspian, Peshkov said that Russia is not opposed but would insist on double-hulled tankers to protect the environment. Bryza replied that the United States would have no problem with such a development as it is our understanding that this is what shipping companies in the Caspian plan. To Pehskov's observation that cross-Caspian oil transport is economically "very tight", Bryza explained the economic attractiveness of expanding Baku-Tbilisi-Ceyhan that would play into commercially sound cross-Caspian transport.

COMMENT

¶17. (C) The visit provided the opportunity to hear broad views across a range of energy issues touching on Russia. While little new on oil pipelines was forthcoming, the MFA's non-interference stance on trans-Caspian shipments was encouraging. Vainshotk's explanation of the Lithuania and Belarus cutoffs offered nothing new but were the most frank explanation yet of Russia's motivations. On gas, Peshkov's observations suggest Russia is micro-analyzing every aspect of the southern corridor and probing for its weak spots. A clear message from western businessmen, echoed indirectly by the Foreign Ministry, is the centrality of Turkmenistan to the future of Europe's gas diversification. As such, we are well advised to heed calls for adept diplomacy that focuses on embedding our companies upstream as a useful prerequisite for an organically-evolving gas corridor that does not go north. A special effort between Baku and Ashgabat on settling the Kapaz/Serdar ownership dispute would augment such a corridor, as would encouraging the two countries to reach a bilateral settlement on delimitation.

¶18. (C) After years of consolidating the sector at home, Russia's "grand ambitions" abroad seem to be taking a visible shape - Russia is building as completely independent an export infrastructure as possible for its own production while making itself the transit state for Central Asian supply. Meanwhile, like a judo master, Russia will deflect as many attempts as possible by independent actors to access Russia's traditional and new export clients. As the western businessmen observed, however, Russia is facing internal energy challenges that could weaken its power, if not its ambitions. As we promote alternative pipelines and alternative sources of supply, timing, deft diplomacy, and concrete achievable steps are our best bet.

¶19. (U) This cable has not been cleared by DAS Bryza.
Melville